Winter 2006 Issue

MakingCents

A Quarterly Update of the CalPERS 457 Deferred Compensation Program

PRIMARY ASSET CLASSES—THE BUILDING BLOCKS OF YOUR PORTFOLIO

For years, doctors have been urging patients to eat a healthy balanced diet that includes the five major food groups: breads and grains, meat, dairy, fruits and vegetables.

But there's another kind of "diet" you should pay attention to: your investing diet. Healthy investment habits are based on including three major groups, or asset classes, in your portfolio. Each asset class provides different benefits:

Equity Investments: Stocks and Stock Funds for Growth

When you have "equity" in something, you have ownership in it. This is why stocks and stock funds are called "equities." When you buy stock, you actually become a part owner in that company. When you invest in stock funds, you pool your money with that of other investors, and a professional investment manager buys and sells stock within the fund in keeping with investors' objectives.

How You Make Money with Stocks

Of course, you hope that the company will do well so that as an shareowner, you will enjoy a profit from its success. Depending on the type of stock you own, you may also earn regular income from dividend payments. Remember, however, that stocks can decrease in value, too, for a number of reasons. For example, the company may have an "off" year, its competitors may be offering better or less expensive products, or the economy — and product demand — may slow down.

What Can Affect Stock Prices?

If the company does well, or even if people simply expect the company to do well, more investors may buy shares, which causes the stock price to rise. If, on the other hand, the company does poorly — or people expect it to — shareowners may sell their stock, which causes the price to drop.

What to Watch for When Investing in Stocks

When you own stock or shares in a stock fund, you place your investment in more than the hands of the company's management team. It's important to realize that your stock's value may also be influenced by trends in the overall stock market, in a particular segment of the stock market, or in a particular industry — none of which you have any control over. Intangible factors such as consumers' attitude toward the company or its products as well as investors' attitude about the market and investing in general may also affect stock price.

Risks and Rewards Associated with Stocks

Compared with other investments, history has shown that stocks have offered the greatest potential for growth

continued on page 2

and outpacing inflation over time. The flip side is no one can predict which companies will do well over time, which is why stocks are the most unpredictable of the major asset classes. This means they can be "volatile" — their prices can go up and down without warning. For investors who can sit tight through market swings and have a long-term perspective of ten years or more, however, short-term volatility is usually not cause for concern.

Fixed-Income Investments: Bonds and Bond Funds for Income

When you invest in a fixed-income security such as a bond or bond fund, you're really lending money to a corporation or government entity. Unlike buying stock, you don't own a piece of the company or government entity. Instead you "own" a piece of their debt obligation (their obligation is to repay you). The most common types of fixed-income assets are bonds and bond funds.

How You Make Money with Bonds

The main goal of a fixed-income investor is to earn interest on the amount loaned. It's called "fixed-income" because you earn a fixed amount of interest on a regular schedule, so you can count on it as income. With a bond fund, the second goal is to profit from any price increases of the securities held, which could raise the overall value of the fund. As with stock funds, there is the possibility that the fund's value could drop.

What Can Affect Bond Prices

When interest rates rise, the value of the securities in a fixed-income fund tend to drop. Why? Because investors are more likely to buy a newly issued security paying higher interest than the securities already on the market that pay a lower interest rate. Not surprisingly, when interest rates drop, investors would rather pay more for the higher-interest securities already on the market than for the lower-interest, newly issued ones.

Risks and Rewards Associated with Bonds

Most fixed-income funds tend to be less risky than stock funds, in part because investors are buying the bond or investing in the bond fund to hold and earn interest. However, there are higher-risk fixed-income funds, such as junk bonds, which come attached with the risk that the issuers won't be able to meet their interest payment obligations.

What to Watch for When Investing in Bonds

The main thing to watch for is any change in general interest rates after you've invested. If rates rise, the value of your bond fund holding may decline. But if rates drop, the fund's value may rise. Either situation could affect the amount available in the fund should you decide to withdraw money. You may also want to watch for any changes in the borrower's credit rating: The worse the borrower's cash flow, the greater the potential for late or non-payments on your bond.

Short-Term Investments: Money Markets, Stable Value Funds, and Cash Equivalents for Preservation of Principal

The third main asset class is short-term investments also known as cash and "cash equivalents" or securities that can easily be converted into cash. Money market funds are the most common cash equivalent. These funds lend money to high-quality borrowers for very short periods of time, often just over night (in the morning, the borrower repays the full amount borrowed plus a small amount of interest as the fee). Stable value funds, or GICs (guaranteed investment contracts) pay a guaranteed interest rate over the term of a contract, usually one to five years. The purpose of this asset class is to provide maximum protection of principal. Some investors use money market funds as a "parking spot" for their investment money while they decide how to best invest it in equity or fixed-income investments which have higher growth potential.

How You Make Money with Short-Term Investments

Like bonds, you earn interest on these loans. The amount earned, however, is very small because the loans are short-term and the risks are minimal.

Risks and Rewards with Short-Term Investments

Short-term investments such as money market funds and Treasury Funds (high-quality I.O.U.s from the U.S. federal government) provide the most safety. They also provide the most "liquidity," meaning they can be easily converted into cash. These types of investments are

continued on page 3

Primary Asset Classes—continued from page 2

not risk-free, however: due to their minimal growth potential, they may not be able to out pace inflation. Investors who put a major portion of their retirement investments into money market and similar funds run the risk of a retirement shortfall — the risk that their money will not grow enough to cover retirements costs.

Conclusion

Like maintaining a well-rounded, nutritional diet, establishing a thorough investment plan that includes some combination of these three asset classes has definite benefits. First, it helps you to diversify your investments, which may reduce overall market risk and boost your portfolio's growth potential. Second, it helps you take advantage of opportunities in several different markets at once. The proper percentage that each asset class takes up within your portfolio depends on whether your goals are short-term or long-term, and how comfortable you feel with the ups and downs that are normal to investing.

FUND PERFORMANCE

CalPERS 457 Deferred Compensation Performance Report

(Return as of September 30, 2005)

	1 Year	3 Year	Inception to Date	Inception Date
Core Funds				
Money Market Fund	1.99%	1.0%	3.08%	1/31/95
Bond Fund	0.77%	1.64%	5.72%	1/31/95
Stable Fixed-Income Fund	3.83%	3.89%	4.75%	1/31/95
S&P 500 Equity Index Fund	11.85%	16.29%	10.42%	1/31/95
Active Large Cap Equity Fund	14.45%	14.44%	6.74%	1/31/95
Russell 2000 Index Fund	17.34%	23.34%	6.94%	6/30/99
Active Small Cap Equity Fund	15.86%	18.49%	9.97%	3/31/95
International Equity Fund	27.09%	21.33%	2.82%	3/31/95
Asset Allocation Funds				
Conservative Allocation Fund	7.66%	9.41%	6.64%	3/31/95
Moderate Allocation Fund	10.98%	12.89%	7.71%	3/31/95
Aggressive Allocation Fund	13.62%	15.82%	6.44%	3/31/95
FDIC Insured Investments				
Insured Money Market Account	0.24%	0.34%	1.85%	**9/30/96**

Returns shown are net of investment management and plan level expenses. Historical performance is not necessarily indicative of actual future investment performance, which could differ substantially. Investment return and principal value may fluctuate so that your investment, when redeemed, may be worth more or less than the contributions to your individual account.

Beginning June, 2005, the CalPERS 457 Program began offering FDIC-insured CD's exclusively through the Self-Managed Account (SMA) Option. Each participant account will be eligible for FDIC insurance coverage up to $100,000 for the aggregate of all FDIC-Insured deposits held within the CalPERS 457 Program.

DISTRIBUTION CHOICES:

Taking a Distribution from Your 457 Deferred Compensation Plan

Decisions, Decisions

Your CalPERS 457 deferred compensation plan is an excellent way to accumulate tax-deferred savings. However, making decisions can be complicated. How much should I contribute? How should I invest my money? Finally, which distribution option should I choose? This is probably the most complex question.

You are eligible to take a distribution once you have separated from service with your employer and you must begin receiving distributions by no later than the year in which you reach age 70 1/2. An option that is often overlooked is that you may leave your money in the plan. However, you must begin receiving payments in the year in which you reach age 70 1⁄2, unless you are still employed. In such a case, you may not be required to begin receiving payments, depending on the terms of your plan.

continued on page 4

REMINDER!

The maximum contribution limit for 2006 has increased to $15,000 per year plus an additional $5,000 for participants age 50 and over.

Now is a good time to review your investment strategy for the coming year.

Distribution Options*

There are basically four distribution types a plan may offer:

- **Lump Sum**—you may take all of your money in one lump sum cash payment.
- **Installments**—you may choose to receive payments over a period of time (installments over a specified number of months, years or a specific dollar amount each month or year for a designated time period or a combination of these options).
- **Rollovers**—you may rollover your entire balance or a portion of it to an IRA, qualified retirement plan, or a new employer's 457 plan, 401(k) plan or 403(b) plan.
- **Annuities**—Annuities are contracts that can be purchased to establish a fixed monthly income for life that is actuarially equivalent to the balance in your plan. Basically, you exchange your plan balance for this stream of fixed payments. All annuity payments are taxable as current income. Some annuity options may require minimum account balances.

Beneficiary Options

If you have a balance in the plan upon your death, your spouse has the same distribution options that you had, but payments must begin no later than when you would have attained age 70 1⁄2. Payments must be completed within your spouses' life expectancy. If your beneficiary is not your spouse, the beneficiary must begin receiving payments over his or her life expectancy by December 31st of the year following your death, or otherwise must take the entire balance by December 31st of the fifth year following your death.

Requesting Your Distribution

The CalPERS 457 Plan permits lump sum, partial lump sum, installments, rollovers and any combination of these forms of distribution. All distributions are paid directly from the funds in the plan. You may also elect to purchase an annuity contract from a commercial insurer with all or a portion of your account.

You are eligible to receive a distribution whenever you sever employment. If you have rolled money into the CalPERS 457 Plan from an IRA, or previous employer's 401(a), 401(k), or 403(b) plan, a recent IRS ruling now lets you take distributions from that rollover amount before you sever employment. You do not have to begin distribution until you reach age 70 1⁄2 but it is good practice to file a notice with us through your employer at the time you sever employment so that your eligibility to begin distribution at any time is established. When you are ready to begin distribution, simply file a Request for Distribution form with us indicating your distribution choice. We permit you to start, stop, or change your distribution as long as you provide us at least 30 days notice before the change is to take effect.

When and how you take a distribution is an important decision. The CalPERS 457 Plan gives you liberty to set up a distribution plan that fits your needs, and flexibility to change your distribution plan if you need to.

CalPERS 457
Deferred Compensation Program
Customer Service Line:
(800) 260-0659

California Public Employees' Retirement System
Supplemental Savings Programs
P.O. Box 942713
Sacramento, CA 94299-2713

MakingCents is published quarterly for the CalPERS 457 Deferred Compensation Program.

Anne Stausboll
Assistant Executive Officer
Investments Office

Dave Mullins
Chief
Supplemental Savings Program

www.calpers.ca.gov

CalPERS